

**SUMMARY ANALYSIS OF AMENDED BILL**

Author: Klehs Analyst: John Pavalasky Bill Number: AB 115  
 Related Bills: \_\_\_\_\_ Telephone: 845-4335 Amended Date: May 27, 2005  
 Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Conformity Act of 2005

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED May 2, 2005, STILL APPLIES.

☒ OTHER – See comments below.

**SUMMARY**

This bill would change California's specified date of conformity to federal income tax law from January 1, 2001, to January 1, 2005, and thereby, in general, conform to the numerous changes made in federal income tax law during that four-year period.

**SUMMARY OF AMENDMENTS**

The May 27, 2005, amendments removed conformity to the passive activity loss (PAL) rules for real estate professionals and, starting in 2007, added full conformity to the federal student loan interest rules.

**EFFECTIVE/OPERATIVE DATE**

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2005. The provisions of this bill that conform to federal provisions that are subject to the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) termination date would apply to taxable years beginning before January 1, 2011. The May 27, 2005, amendments specifically make full conformity to the student loan interest rules apply to taxable years beginning on or after January 1, 2007. In addition, the bill specifically provides that conformity to the federal health savings account (HSA) provisions are retroactive and are to be applied to taxable years beginning after December 31, 2003, with amended returns allowed.

Board Position:

\_\_\_\_\_ S \_\_\_\_\_ NA \_\_\_\_\_ NP  
 \_\_\_\_\_ SA \_\_\_\_\_ O \_\_\_\_\_ NAR  
 \_\_\_\_\_ N \_\_\_\_\_ OUA ☒ PENDING

Legislative Director

Date

Brian Putler

6/9/05

## **POSITION**

Pending.

The EFFECTIVE /OPERATIVE DATE and ECONOMIC IMPACT portions of the previous analysis of the bill as amended May 2, 2005, have been updated. In addition, an analysis of the student loan interest conformity provision is provided. The POSITION, LEGAL IMPACT, and ARGUMENTS/POLICY CONCERNS have not changed but are restated for convenience. The remainder of the analysis of the bill as amended May 2, 2005, still applies.

## **ANALYSIS OF STUDENT LOAN INTEREST PROVISION**

### FEDERAL/STATE LAW

Under current state law and federal law before the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable annual deduction is \$2,500. The deduction is phased-out ratably for single taxpayers with modified adjusted gross income between \$40,000 and \$55,000 and for married taxpayers filing joint returns with modified adjusted gross income between \$60,000 and \$75,000.

### Current Federal Law

For years starting in 2002 or later, EGTRRA increased the income phase-out ranges for eligibility for the student loan interest deduction to a range from \$50,000 to \$65,000 for single taxpayers and a range from \$100,000 to \$130,000 for married taxpayers filing joint returns. These income phase-out ranges are adjusted annually for inflation.

EGTRRA also repealed both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible.

Current California Law

Under current state and federal law the maximum allowable annual deduction is \$2,500. However, California did not conform to the EGTRRA change to the phase-out ranges for this deduction. Thus, the California deduction is still phased-out ratably for single taxpayers with modified adjusted gross income between \$40,000 and \$55,000 and for married taxpayers filing joint returns with modified adjusted gross income between \$60,000 and \$75,000. Also, California law retains the provision that the deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. In addition, current California law still provides that required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Note that months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period.

THIS BILL

For years starting in 2007 or later, the May 27, 2005, amendments would conform to the federal income phase-out ranges for eligibility for the student loan interest deduction. That is, a phase-out range from \$50,000 to \$65,000 for single taxpayers and a range from \$100,000 to \$130,000 for married taxpayers filing joint returns, both as adjusted for inflation.

For years starting in 2007 or later, the May 27, 2005, amendments would also repeal both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible.

**SUMMARY OF ECONOMIC IMPACT**

Revenue Estimate AB 115 As Amended May 27, 2005 – Changes to Table in Bold

Conformity to Provisions Changed in Federal Law Before 2004  
Applies to Taxable Years Beginning On Or After January 1, 2005, Except as Noted

Federal Act Section	Description	(In millions)		
		2005-06	2006-07	2007-08
<b>412</b>	<b>Economic Growth and Tax Relief Act of 2001 (PL 107-16) - Student Loan Interest.</b>	<b>\$0</b>	<b>-\$8</b>	<b>-\$15</b>
404	JCWAA of 2002 (P.L. 107-147) - Expansion of the exclusion from income for qualified foster care payments.	-\$4	-\$3	-\$3
1201	Medicare Prescription Drug, Improvement, And Modernization Act of 2003 (P.L. 108-173) - Health savings accounts. Applies to taxable years beginning after December 31, 2003, with amended returns allowed.	-\$29	-\$18	-\$23

Conformity to the WFTRA of 2004 (PL 108-311)  
And The AJCA (PL 108-357)

Applies to Taxable Years Beginning On Or After January 1, 2005

Federal Act Section	Provisions	(In millions)		
		2005-06	2006-07	2007-08
WFTRA 201-208	Uniform definition of child, etc.	-\$10	-\$7	-\$7
320	Disclosures relating to terrorist activities	-	-	-
322	Extension of expiring provisions-Availability of medical savings accounts	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
401-408	Technical amendments	-	-	-
AJCA 231	Members of family treated as 1 shareholder	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
232	Increase in number of eligible shareholders to 100	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
233	Expansion of bank S corporation eligible shareholders to include IRAs	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
234	Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
235	Transfer of suspended losses incident to divorce, etc.	b/	b/	b/
236	Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries	b/	b/	b/
237	Exclusion of investment securities income from passive income test for bank S corporations.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
238	Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations	b/	b/	b/
239	Information returns for qualified subchapter S subsidiaries.	b/	b/	b/
240	Repayment of loans for qualifying employer securities	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
243	Improvements related to real estate investment trusts	b/	b/	b/
247	Modification of unrelated business income limitation on investment in certain small business investment companies	b/	b/	b/
311	Special rules for livestock sold on account of weather-related conditions	-\$1	-\$1	f/
312	Payment of dividends on stock of cooperatives without reducing patronage dividends.	b/	b/	b/
315	Capital gain treatment under Section 631(b) to apply to outright sales by landowners.	b/	b/	b/
318	Certain expenses of rural letter carriers	b/	b/	b/
320	Exclusion for payments to individuals under National Health Service Corps loan repayment program and certain State loan repayment programs	b/	b/	b/

321	Modification of safe harbor rules for timber REITs.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
322	Expensing of certain reforestation expenditures	-\$1	-\$1	f/
331	Net income from publicly traded partnerships treated as qualifying income of regulated investment companies	b/	b/	b/
335	Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	b/	b/	b/
338	Expensing of capital costs incurred in complying with Environmental Protection Agency sulfur regulations. Revenue same as AB 810 (Parra) as introduced. [2]	d/	b/	a/
339	Credit for production of low sulfur diesel fuel. Revenue same as AB 810 (Parra) as introduced. [2]	d/	-\$1	-\$1
702	Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income	b/	b/	b/
703	Civil rights tax relief	-\$1	-\$1	-\$1
704	Modification of class life for certain track facilities	-\$1	-\$1	-\$1
706	Certain Alaska natural gas pipeline property treated as 7-year property	\$0	\$0	\$0
708	Method of accounting for naval shipbuilders	-\$4	-\$7	-\$6
709	Modification of minimum cost requirement for transfer of excess pension assets.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
811-820	Provisions relating to reportable transactions and tax shelters	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
831	Treatment of stripped interests in bond and preferred stock funds, etc.	e/	e/	c/
833	Disallowance of certain partnership loss transfers	e/ +Baseline gain [1]	e/ +Baseline gain [1]	e/ +Baseline gain [1]
834	No reduction of basis under Section 734 in stock held by partnership in corporate partner	e/	e/	e/
835	Repeal of special rules for FASITS	a/	a/	a/
836	Limitation on transfer or importation of built-in losses	e/ +Baseline gain [1]	\$1 +Baseline gain [1]	\$1 +Baseline gain [1]
838	Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions	a/	a/	a/
839	Clarification of rules for payment of estimated tax for certain deemed asset sales.	\$2	\$1	-
840	Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within 5 years of sale	\$1	\$1	\$1
841	Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons	\$2	\$3	\$1
842	Deposits made to suspend running of interest on potential underpayments	-\$2	d/	d/
843	Partial payment of tax liability in installment agreements.	\$1	c/	f/

845	Expanded disallowance of deduction for interest on convertible debt	\$3	\$3	\$3
847-849	Reform of tax treatment of certain leasing arrangements	\$3 +Baseline gain [1]	\$4 +Baseline gain [1]	\$5 +Baseline gain [1]
882	Treatment of charitable contributions of patents and similar property	e/	e/	e/
883	Increased reporting for noncash charitable contributions	a/	a/	a/
884	Donations of motor vehicles, boats, and airplanes	\$7	\$8	\$8
885	Treatment of nonqualified deferred compensation plans	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
886	Extension of amortization of intangibles to sports franchises	\$3	\$3	\$1
888	Modification of straddle rules	\$1	\$1	\$1
896	Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest	\$2	\$1	\$1
897	Denial of installment sale treatment for all readily tradable debt.	\$2	\$1	e/
898	Modification of treatment of transfers to creditors in divisive reorganizations	e/	e/	e/
899	Clarification of definition of nonqualified preferred stock	c/	c/	c/
902	Consistent amortization of periods for intangibles	\$5	\$15	\$15
903	Freeze of provisions regarding suspension of interest where Secretary fails to contact taxpayer [2]	\$2	\$2	\$1
905	Treatment of sale of stock acquired pursuant to exercise of stock options to comply with conflict-of-interest requirements	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
907	Limitation of employer deduction for certain entertainment expenses	\$6	\$6	\$7
	<b>TOTAL (excluding baseline estimates and footnoted estimates)</b>	<b>-\$13</b>	<b>\$2</b>	<b>-\$12</b>

[1] For baseline estimates see revenue impact discussion in the individual sections.

[2] Estimates based on State data. Otherwise, all estimates are based on Federal pro-rations.

a/ Insignificant gains of less than \$150,000

b/ Insignificant losses of less than \$150,000

c/ Negligible gains of less than \$250,000

d/ Negligible losses of less than \$250,000

e/ Minor gains of less than \$500,000

f/ Minor losses of less than \$500,000

## **LEGAL IMPACT**

This bill contains provisions that would target certain provisions relating to low-sulfur diesel fuel to California.

The U.S. Court of Appeals for the 6<sup>th</sup> Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its effects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

Recently introduced federal legislation titled the "Economic Development Act of 2005," S. 1066 and H. R. 2471, would authorize state tax incentives for economic development purposes that may otherwise be subject to constitutional challenge as discriminatory.

## **ARGUMENTS/POLICY CONCERNS**

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Additionally, the taxpayer needs to maintain only one set of books. Conformity also eases the burden of the Franchise Tax Board to administer the law by utilizing many federal forms, instructions, and regulations. In addition, whenever possible the department uses federal information to verify that taxpayers pay the proper amount of tax. This eliminates the need for the taxpayer to submit the same information to both the IRS and the department.

## **LEGISLATIVE STAFF CONTACT**

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